30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **November 2007, London**

Project: **Compliance Costs for REACH (Agenda Paper 3)**

I. INTRODUCTION

Background

1. The IFRIC received a request to add an issue to its agenda to provide guidance on the treatment of costs incurred to comply with the requirements of the European Regulation concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH). In the July meeting, the IFRIC agreed with the staff's recommendation that it should tentatively add this issue to its agenda.

2. In the July meeting, the IFRIC noted that jurisdictions other than Europe had developed or were in the process of developing regulations relating to similar environmental issues. Consequently, the IFRIC recommended that the staff should analyse the issue on the basis of general principles rather than the specifics of any particular legislation.

Purpose of this paper

3. Purpose of this paper is primarily to consider whether this issue meets the criteria for being added to the IFRIC agenda.

4. In answering that question, the paper also considers whether the IFRIC will be able to reach a consensus on the issue in a reasonable timeframe. To aid the discussion, the paper proposes ways in which the IFRIC may define the scope of its work in order to maximise the likelihood of reaching a consensus.

5. The paper comprises 6 sections:

   I. Introduction

   II. Key features of new regulation

   III. Accounting standards and practices

   IV. Accounting issues and alternative views under IFRS

   V. Assessment of the agenda criteria

   VI. Proposed scope of the project

II. KEY FEATURES OF NEW REGULATION

Key features of new chemical regulation

6. The staff is not aware of regulations similar to REACH that are currently in place in non-EU jurisdictions, however chemical regulations are being strengthened in North America and Asia. REACH is recognised as a pioneer model for the comprehensive "**self-assessment**" type chemical regulation in the world.

7. The staff noted that REACH has new key features as compared to the former regulation:

   - REACH is based on the concept of **self-responsibility**, i.e. the industry itself (not the government or an Agency) is in the best position to ensure that the substances it manufactures and markets do not adversely affect human health and the environment;

- chemicals can only be marketed **after** their ingredients have been registered, i.e. if a company fails to register a substance it means that this company is no longer allowed to manufacture or import this substance;
- entities will bear **significant costs** for registration, which are not only registration fees but also significant testing costs (internal and external laboratory costs), preparation of the registration documents.

Overview of REACH requirements

8. A brief overview of REACH is included in the paragraphs below. For convenience, the key terms are highlighted in bold. Further details of the regulation are available at the web site.

- Reach in brief: http://ec.europa.eu/environment/chemicals/reach/pdf/2007_02_reach_in_brief.pdf
- Regulation: http://eur-lex.europa.eu/LexUriServ/site/en/oj/2007/l_136/l_13620070529en00030280.pdf

Concept – self responsibility

9. REACH is based on the idea that industry itself is best placed to ensure that the chemicals it manufactures and puts on the market in the EU do not adversely affect human health or the environment. This requires industry to have certain knowledge of the properties of its substances and to manage potential risks.

10. Authorities should focus their resources on ensuring industry is meeting its obligations and taking action on substances of very high concern or where there is a need for Community action.

11. Under the former EC legislative framework for chemical substances, public authorities were responsible for undertaking risk assessments of substances rather than the enterprises that manufacture, import or use the substances; and these risk assessments were required to be comprehensive, rather than targeted and use-specific.

Scope – what kind of chemical is in the scope? who should be responsible for registration?

12. REACH is very wide in its scope covering all **substances**[1] whether manufactured, imported, used as intermediates or placed on the market, either on their own, in **preparations**[2] or in **articles**[3]. Waste is specifically exempted[4].

13. Food that meets the definition of a substance, on its own or in a preparation, will be subject to REACH however, such substances are largely exempted from Registration, Evaluation and Authorisation.

14. Substances that are used exclusively for product and process oriented research and development are exempt from registering under REACH for five years.

15. **Downstream users** are exempt from registration if the substance has been registered for that use. A downstream user is defined as a person or entity that uses a substance, either on its own or in a preparation, in the course of their industrial or professional activities, including producers or importers of articles containing that substance.

16. Downstream users may be any industrial user of chemicals, whether formulators of preparations (e.g. paint producers) or users of chemicals such as oils and lubricants in other industrial processes or producers of manufactured articles such as electronic components. They are required to consider the safety of their uses of substances, based primarily on information from their suppliers, and to apply appropriate risk management measures.

Registration is required for the manufacturers or the importers before their manufacturing or placing on the market of substances

17. **Registration** means that a manufacturer or an importer has provided a registration dossier to the Agency and has not received any indication that it is incomplete. This does not by itself mean that the dossier is in compliance with

[1] **substance**: A chemical element and its compounds in the natural state or obtained by any manufacturing process, including any additive necessary to preserve its stability and any impurity deriving from the process used, but excluding any solvent which may be separated without affecting the stability of the substance or changing its composition.
[2] **preparation**: A mixture or solution composed of two or more substances.
[3] **article**: An object, which during production is given a special shape, surface or design that determines its function to a greater degree than does its chemical composition. Examples are manufactured goods such as cars, textiles and electrical chips.
[4] REACH regulation Article 2.2

the legislation nor does it mean all the properties of the registered substance have been identified.

18. There is a general obligation for manufacturers and importers of substances to submit a registration to the Agency for each substance manufactured or imported in quantities of 1 tonne or above per year.

19. To reduce the overall costs of the program, registrants are required to jointly submit information on the hazardous properties of the substance and its classification, and can, if they agree, also jointly submit the chemical safety report ("**joint submission**"). The intention is that registrants will save money by co-operating on the preparation of the dossier.

20. If a company fails to register a substance it means that this company is no longer allowed to manufacture or import this substance. Manufacturers and importers of substances need to provide information on the substances they manufacture or import to their customers. They need to assess the risks arising from the uses and need to provide their customers with guidance on safe use.

21. "Registration" requires manufacturers and importers to submit:

    • a **technical dossier**[5], for substances manufactured or imported in quantities of 1 tonne or more, and

    • a **chemical safety report**[6], for substances manufactured or imported in quantities of 10 tonnes or more

22. For substances of very high concern, an **authorisation** is required for their use and their placing on the market. These substances have hazardous properties of such high concern that it is essential to regulate them centrally through a mechanism that ensures that the risks related to their actual uses are assessed, considered and then decided upon by the Community.

23. An authorisation will be granted if the applicant can demonstrate that the risk from the use of the substance is adequately controlled. If not, then it may also

[5] The **technical dossier** contains information on the properties, uses and on the classification of a substance as well as guidance on safe use.

[6] The **chemical safety report** (CSR) for substances manufactured or imported in quantities starting at 10 tonnes, documents the hazards and classification of a substance and the assessment as to whether the substance is a very high risk substance.

be granted if the socio-economic benefits outweigh the risks and there are no suitable alternative substances or processes.

Data sharing and cost sharing between registrants

24. To reduce testing on vertebrate animals, **data sharing** is required for studies on such animals. For other tests, data sharing is required on request by other registrants. The previous registrants and potential registrants must make every effort to ensure that the costs of sharing the information are determined in a fair, transparent and non-discriminatory way.

Evaluation and Restrictions are undertaken by authorities

25. **Evaluation** is undertaken by the Agency for testing proposals made by industry or to check compliance with the registration requirements. The Agency co-ordinates substance evaluation by the authorities to investigate chemicals with perceived risks. This assessment may be used later to prepare proposals for restrictions or authorisation.

26. The **restrictions** provide a procedure to regulate that the manufacture, placing on the market or use of certain dangerous substances shall be either subject to conditions or prohibited. Thus, restrictions act as a safety net to manage Community-wide risks that are otherwise not adequately controlled.

Type of Costs

27. Entities have to pay a **registration fee** for each substance registered with the Agency in accordance with the Regulation.

28. In addition to a registration fee, the entity might have to pay the following costs (Note that these costs are not specified in the Regulation and therefore the following is a non-exhaustive list of costs):

- preparing the technical dossier and the chemical safety report (eg. internal and external documentation costs)
- performing the chemical safety assessment (eg. internal and external laboratory tests)
- IT costs to track information required for REACH registration and supply chain management

III. ACCOUNTING STANDARDS AND PRACTICES

IFRS Literature

29. The IFRSs do not specifically address the issue of compliance costs of REACH.

30. The staff notes that IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* provides guidance on the recognition, in the financial statements of producers, of liabilities for waste management (decommissioning) under the EU Directive on Waste Electrical and Electronic Equipment (WE&EE) in respect of sales of historical household equipment.

31. The European Union's Directive on WE&EE, which regulates the collection, treatment, recovery and environmentally sound disposal of waste equipment, gave rise to questions about when the liability for the decommissioning of WE&EE should be recognised. IFRIC concluded that participation in the market during the measurement period is the obligating event in accordance with paragraph 14(a) of IAS 37.

32. REACH costs and waste management costs required by WE&EE look similar in that they both relate to the compliance costs for potentially harmful stuff (chemicals or electrical equipment).

33. However, the two regulations differ in whether the regulator wants to regulate harmful stuff in the advance stage of the process (REACH) or in the late stage (WE&EE). REACH requires compliance costs **prior to** the marketing of the harmful chemicals. WE&EE requires waste management costs **after** the harmful products are used.

34. The staff also notes that waste itself does not give rise to additional compliance costs under REACH because waste is specifically exempted from REACH (see paragraph 12 of this paper).

35. These differences in the features of the regulations might give rise to different accounting treatment for the compliance costs (discussed below).

Practice

36. Pre-registration of the chemicals started on 1 June 2008 and should be completed by November 30, 2008. Registration should be completed by 2018. The staff reviewed the latest financial statements of the major European chemical companies on a sample basis. The staff notes that accounting policy disclosures about REACH compliance costs are not yet publicly available.

37. The full impact of REACH may not be apparent until an entity completes registration in 2018. However, one of the largest chemical companies estimates annual costs of around Euro 50 million until completion of its implementation in 2018.

38. The European Commission estimates that the costs of REACH to the chemicals industry will be a total of € 2.3 billion. The chemical industry in Europe estimates much higher costs than the EC's estimate.

IV. ACCOUNTING ISSUES AND ALTERNATIVE VIEWS UNDER IFRS

39. Some major accounting firms in their internal or external guidance identify various accounting issues including the key fundamental issues:

- Should a provision for expected REACH costs be recognised?
- Should REACH costs be expensed or capitalised as an intangible asset?

Should a provision for expected REACH costs be recognised?

40. Some have the view that a provision should not be recognised for estimated future registration costs in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

41. This view is based on the assumption that in cases where a manufacturer or an importer fails to register a chemical substance, it will have to pay a penalty but will not be required register subsequently unless it wants to continue manufacturing or importing.

42. They are of the view that there is no present obligation for the manufacturers or importers arising from a past event to register the chemical substances. The registration costs can be avoided by ceasing to use the chemical substances.

43. Constituent views seem consistent on this issue. For clarification, the staff is of the view that the IFRIC should reach a consensus on the application of IAS 37.

Should REACH costs be expensed or capitalised as an intangible asset?

44. Some have a view that REACH costs should be capitalised as an intangible asset. They believe that REACH costs meet the recognition criteria in accordance with IAS 38 *Intangible Assets.*

45. To determine which costs are to be capitalised the individual facts and circumstances should be reviewed thoroughly to determine whether the costs incurred are directly attributable to registration/authorisation and are reliably measureable.

46. Those who support capitalisation believe that REACH costs enable an entity to obtain the future economic benefits received through the entity's use of the chemical substance.

47. They believe that a registration cost is similar to obtaining a legal right or a product specific license.

48. Others argue against capitalising costs. They argue that REACH costs are similar to other compliance costs (such as Sarbanes - Oxley Act. (SOX)) that are normally expensed as general expenses to maintain the business as a whole.

49. However, those who support capitalising costs emphasised that REACH costs are product-specific rather than being necessary to meet requirements related to the business as whole. Those who support capitalising costs also think that REACH costs have same character as the assets installed for environmental or safety reasons (paragraph 11 of IAS 16). Those assets do not directly increase the future economic benefits but they are capitalised because without them the entity is unable to manufacture and sell chemicals.

50. The staff also notes that some prefer to capitalise costs in respect of substances under development (subject to the criteria in IAS 38 being met) and expensing costs in respect of substances already on the market.

51. Some have a view to expense all costs, although there might be an argument to capitalise costs in respect of substances under development (subject to the criteria in IAS 38 being met).

52. Consequently, the staff is aware that the constituents have various views in connection with REACH compliance costs.

Related issues

53. The staff notes that the large firms have also identified a number of related issues including:

- If compliance costs are capitalised, what parts of costs should be capitalised?
- If REACH costs should be capitalised, is the intangible asset separately acquired or internally generated?
- How should the reimbursement of costs from additional registrants be accounted for?
- Is there an intangible asset when registration has been obtained as part of a consortium?
- Is there an intangible asset arising upon authorisation?
- Is the useful life of the intangible asset finite or indefinite?

V. ASSESSMENT OF AGENDA CRITERIA

54. Based on the IFRIC due process handbook, the IFRIC assesses the proposed agenda item against the following criteria (the issue does not have to satisfy all the criteria to qualify for the agenda):

(a) The issue is widespread and has practical relevance.

(b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice).

(c) Financial reporting would be improved through elimination of the diverse reporting methods.

(d) The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation.

(e) It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.

(f) If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities.

55. The staff's view is that criteria (a), (b) and (c) are likely to be met. As outlined in the above sections, the REACH is applicable to the chemical companies doing business in Europe and has significant practical relevance. Jurisdictions other than Europe may develop regulations relating to similar environmental issues. IFRSs do not specifically address REACH compliance costs. Views are mixed as to how IFRSs should apply. Therefore, it is likely that divergence in practice currently exists or will emerge in the future.

56. The staff considers that the key issues that need to be considered are whether a provision for the compliance costs should be recognised and whether the costs should be expensed or capitalised as an intangible asset. Both of these questions can be resolved within the confines of existing IFRS and the *Framework*. In that sense, the staff believes that the issue is narrow enough to be resolved within the confines of existing IFRS. Therefore, criterion (d) is likely to be met.

57. Criterion (e) is difficult to assess. If the wide range of different views are represented amongst IFRIC members, then it may be difficult for the IFRIC to reach a consensus on the issue.

58. Despite this risk, the staff believes that the IFRIC should be able to reach a consensus so long as it carefully manages the scope of the project. The staff has set out the proposed scope of the project in the next section of this paper.

59. The issue relates to Board's project: Intangibles. However, the project on Intangibles is a research project and the first step is to determine the scope and a process for continuing such research work. Therefore, criterion (f) is likely to be met.

60. Therefore, the staff recommends that the IFRIC confirm its tentative decision to add this issue to its agenda.

Question for the IFRIC

61. Do you agree with staff recommendation in paragraph 60?

VI. POSSIBLE SCOPE OF THE PROJECT

62. The staff has considered that the scope could be specified as follows:

- whether the scope of compliance costs should be limited to major cost items
- whether the legal scheme of the registration should be discussed

Whether the scope of compliance costs should be limited to major cost items

63. As noted in paragraphs 27-28, the compliance costs will vary. IT costs to track information required for REACH registration and supply chain management will include internal-use software and purchased software.

64. IAS 38 applies to the recognition and measurement of software costs. The staff do not see any particular reasons to develop further guidance for IT costs arising in connection to REACH.

65. Therefore, the staff recommend that the costs dealt with in the project should be limited to major costs such as a registration fee paid to the agency, a testing fee and costs for preparation of the registration documents.

Whether the legal scheme of the registration should be discussed

66. As noted in paragraphs 19 and 24, REACH supports joint submissions to reduce overall costs and data sharing among the registrants. For joint submissions, multiple registrants will form a consortium.

67. As directed by the IFRIC at the July meeting, the general principles should be set out in this project. The project should conclude the general principle irrespective of how registration has been obtained. Therefore, the project should not deal with the specific legal scheme of registration and the related accounting issues such as how to account for cost sharing among multiple registrants.

Summary of staff recommendations

68. The type of regulations included in the scope of this project should include those with the key features noted in paragraph 7: self-assessment of risk and registration requirement prior to marketing or importing.

69. The following main issues should be addressed:
- Should a provision for expected compliance costs be recognised?
- Should compliance costs be expensed or capitalised as an intangible asset?

70. The staff propose that the scope could be defined as follows:

- the scope of compliance costs is limited to major cost items
- the project does not deal with the legal scheme of the registration

Question for the IFRIC

71. Do you agree with staff recommendation on the proposed scope of this project in paragraphs 62 to 67?